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C O N F I D E N T I A L SECTION 01 OF 04 CARACAS 001721

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NSC FOR TSHANNON AND CBARTON
ENERGY FOR DPUMPHREY AND ALOCKWOOD

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TAGS: EPET EINV VE
SUBJECT: OIL COMPANIES WITH OPERATING SERVICE AGREEMENTS FACE ADDITIONAL PRESSURE

REF: CARACAS 1496

Classified By: ECONOMIC COUNSELOR RICHARD SANDERS, FOR REASONS 1.4 (B) AND (D)

SUMMARY

¶1. (C) The foreign oil companies holding Operating Service Agreements (OSAs) signed in three bid rounds in the Venezuelan oil liberalization of the 1990's (the "apertura") are now facing additional pressure from the GOV to migrate these contracts to mixed companies/joint ventures under the 2001 Hydrocarbons Law. The companies have now received a proposed "Transition Agreement" from the GOV which would force them to recognize that their contracts are illegal and would take away their rights to international arbitration. In a June 6 luncheon with Codel Renzi, Royal Dutch Shell's General Counsel confirmed that PDVSA had asked it to sign the document by Friday, June 10. Tactics to pressure the companies include announcements of tax increases (and bills for alleged back taxes) and a requirement that companies take in local currency money due for internal costs incurred. GOV pressure also includes constant assertions of the unfairness and illegality of the OSAs, which oil companies fear may lead to a lasting negative impression of them among Venezuelans. End Summary.

A SERIES OF BLOWS

¶2. (C) On April 14, Energy Minister/PDVSA President Rafael Ramirez announced that the GOV would force the migration of the 32 OSAs to mixed companies by the end of 2005. (Note: Under the OSAs companies have received a per-barrel fee for producing on PDVSA's behalf and relatively favorable royalty and income tax treatment, including the ability to write off development and operating expenses against their tax liability. End note.) At that time, Ramirez said for the first time that the OSA contracts were illegal because they had never been approved by the National Assembly and that they were not true "service" contracts. On April 15, President Chavez announced an increase in the tax rate on oil projects. On April 20, Minister Ramirez clarified that only the OSAs (and not the four Orinoco heavy oil belt joint ventures) would be subject to an increase in the tax rate from 34 to 50 percent and that the tax increase would be effective as of April 18. On May 10, a senior GOV tax official stated that the OSA companies had cheated on their taxes to the tune of some $2 billion over the past ten years and that it would perform tax audits retroactive to 2001. (Note: Local attorneys confirm that the audits will only be retroactive to 2001 because of a statute of limitations written into Venezuelan tax law. End note.)

¶3. (C) Most recently, on May 15, President Chavez announced that PDVSA would no longer pay foreign oil company expenses in dollars. And on May 25, Minister Ramirez addressed the National Assembly and made additional allegations against both the OSA and heavy oil projects. Company officials note that Energy Vice Minister Bernard Mommer was at Ramirez's side during his National Assembly appearance and that Mommer is now participating in their meetings with PDVSA. They credit Mommer with orchestrating the GOV strategy toward them and point to his career as an academic in which he studied how to maximize collection of oil rents on the part of the state.

EVEN CHEVRON TAKES A HIT

¶4. (C) Although the noise level against all the foreign companies in the OSAs has increased dramatically in the past month, it is most notable that Chevron's Boscan oil field contract has now been singled out by senior GOV officials. Despite the fact that Chevron has seemed to have the inside track with this government (most notably in being named, together with Spain's Repsol, to develop one of the blocks of the Deltana Platform natural gas project), in his May 25

address to the National Assembly Rafael Ramirez stated that the Boscan field Operating Service Agreement had been a non-competitive direct award for a field producing 86,000 b/d) far from being a marginal field. Ramirez's comments on the Boscan field have since been reiterated by Deputy Rodrigo Cabezas, the head of the National Assembly committee investigating the contracts between the international oil companies and PDVSA. Cabezas has gone so far as to say that the contract should be revoked which has raised significant concern among Chevron managers in Venezuela.

CONTRACT MIGRATION

¶5. (C) Econoff met on May 23 with Eulogio del Pino, President of the Corporacion Venezolana de Petroleo (CVP, the PDVSA subsidiary which manages contractual relationships with foreign oil companies) who explained that the GOV now envisions a three-step process for the migration of the OSA contracts. According to del Pino, the first step in the process is the valuation of the existing contract assets. The second step will be the valuation of the proposed joint venture assets, while the third would be the negotiation of the structure of the mixed company/joint venture. Del Pino also informed econoff that during this negotiation period, PDVSA would not pay any OSA contract holder more than 66.67 percent of the value of each barrel it produced, i.e., taking for the government the 30 percent royalty and an approximately three percent administrative fee.

¶6. (C) Del Pino also informed econoff that the GOV would shortly ask the OSA companies to sign a Transition Agreement ("Convenio Transitorio"). Copies of this draft agreement were subsequently received by the companies on June 2-3. The agreement cites that PDVSA will only pay a maximum 66.67 percent fee, and requires the "contractor" to pay all taxes owed to Venezuela's tax authorities. Signature would also require the signing companies to recognize that their contracts are illegal and would take away their rights to international arbitration. In a June 6 luncheon with Codel Renzi offered by the Venezuelan Hydrocarbons Association, Royal Dutch Shell's General Counsel confirmed that PDVSA had asked it to sign the document by Friday, June 10. (Note: The GOV is asking companies to sign this document before they have received from the government the draft text of the proposed mixed company/joint venture agreement. End note.)

¶7. (C) In meetings with a number of the OSA companies in the week of May 30, econoffs were told that despite the fact that the GOV has been saying publicly that several companies are well advanced in this process, it is doubtful that any company has yet completed the initial valuation of its OSA assets, although Spain's Repsol is rumored to be the farthest along in this process. (Note: ExxonMobil, a minority partner in the Quiamare-La Ceiba OSA operated by Repsol, told econoffs May 31 that Repsol has not yet approached it about its proposed negotiating posture. End note.) Despite the fact that the GOV appears to be starting this negotiating process with companies such as Repsol from its favored country partners, it is unlikely that it will allow any one company to get too far ahead of the pack. One international oil company president commented to econoffs that the GOV will probably advance the negotiations at the same pace in order to extract maximum concessions from all the companies.

DOLLAR PAYMENTS

¶8. (C) Econoffs were told by several companies that they have yet to receive their first quarter or April monthly payments from PDVSA (some companies receive their "service" fee on a quarterly basis and others on a monthly basis). It is likely that this delay is linked to Chavez's May 15 announcement about dollar payments although it may also be linked to on-going tax threats. However, a representative of Harvest Vinccler (80 pct owned by U.S. independent Harvest International) attending the Codel Renzi lunch on June 6 said that he had been informed that PDVSA would soon make a payment. A member of the local trade press also informed econoff June 6 that he believes PDVSA will shortly make payments to the companies that will include 70-80 percent dollars and 20-30 percent bolivars. He noted that PDVSA does not yet know how to handle Chavez's May 15 announcement.

¶9. (C) A local attorney informed econoffs that the Venezuelan Central Bank law says that all obligations contracted in foreign currencies are payable in local currency unless the parties expressly provide otherwise. Although some of the OSA contracts have provisions stipulating dollar payments, they do not use the word "exclusively," which, according to this attorney, could allow the GOV to get away with payments in bolivars.

TAXES

¶10. (C) As noted above and reported in reftel, as of April 18, the GOV increased the income tax levied on the OSA operators from 34 percent to 50 percent. On May 10, the GOV declared that the companies had cheated on their taxes to the tune of some $2 billion and that it would perform tax audits retroactive to 2001. It now appears that SENIAT, Venezuela's IRS equivalent, will seek to assess a retroactive 50 percent income tax on the companies for the years 2002-2004 and that 2001 taxes will be retroactively assessed at 67.67 percent, the tax rate in effect in 2001. (Note: the 2001 Hydrocarbons Law, which became effective on January 1, 2002, increased royalties from 16.67 to 30 percent. At the same time, the income tax was reduced from 67.67 percent to 50 percent. The GOV had previously applied a 34 percent income tax rate to the OSA companies because, at that time, they were considered to be simply supplying a service to PDVSA. End Note.)

¶11. (C) Despite numerous press reports since early May that SENIAT has reached agreement on back taxes with multiple companies, econoffs have not been able to confirm this and believe that the GOV has leaked these reports in order to put additional pressure on companies to break ranks. In conversations with a number of the OSA companies the week of May 30, company spokesmen underlined that they do not believe any company has yet come to an agreement with the Seniat. The companies also informed econoffs that SENIAT audit teams have been lodged full time in their offices for months.

¶12. (C) SENIAT authorities have made comments to the press to the effect that as much as $744 million is being retained while companies make good on back taxes owed. A local consulting firm notes that these monies may correspond to VAT reimbursements owed to the 32 operating agreement projects. Most recently, the press reports that Seniat will bill three companies whose audits have been completed. The three include Royal Dutch Shell, Italy's ENI, and Harvest Vinccler.

COMMENT

¶13. (C) The GOV continues its pressure on companies operating in Venezuela's oil sector in a move to extract as much revenue as it can. The fallout from this is growing uncertainty on the part of the companies that complain that their reputations are being unfairly tainted and that they do not understand the ultimate intentions of the GOV. They are worried that they will be perceived negatively by the Venezuelan people and that the vitriolic rhetoric that is accompanying this campaign could well demonize the companies to such an extent that it could put company personnel at risk.

¶13. (C) If taken to its logical conclusion, the claims by the GOV against the OSA companies, and particularly the claim that the contracts are illegal, could also mean that the GOV could refuse to pay the OSA operators again until their assets have been migrated to mixed companies/joint ventures or they sign the Transition Agreement. Any such action by the GOV would only serve to underline the seriousness of what some in the community are now calling "creeping confiscation." It does not appear that the companies will make the hurried decisions to sign the "Transition Agreement" that the GOV wants. This may well open them up to escalating attacks by other Venezuelan Government entities that impact on their operations such as the Labor and Environment Ministries.
Brownfield